

FITCH AFFIRMS PUBLIC FACILITIES FIN AUTH OF SAN DIEGO, CA WASTEWATER REVS AT 'AA'; OUTLOOK STABLE

Fitch Ratings-Austin-12 March 2014: Fitch Ratings has affirmed its 'AA' rating on the following Public Facilities Financing Authority of the City of San Diego, CA (the authority) bonds issued on behalf of the city of San Diego, CA (the city):

--\$1.1 billion in outstanding senior sewer revenue bonds.

The Rating Outlook is Stable.

SECURITY

The bonds are secured by revenues which consist primarily of installment payments made by the city to the authority. The city's obligation to make installment payments constitutes a senior lien on net revenues of the city's wastewater system (the system).

KEY RATING DRIVERS

SOLID FINANCIAL RESULTS: System financial performance is good and benefits from prudent formal policies and reserves.

LEVERAGE TRENDING POSITIVE BUT OUTYEAR CONCERNS: Leverage ratios are moderate overall and are forecasted to improve over the next few years as a result of limited borrowing for capital. Debt levels are likely to increase ultimately (and possibly during the forecast period) through either the movement of Point Loma Wastewater Treatment Plant (PLWTP) to full secondary treatment or the reduction of flows to PLWTP through the construction of a full-scale indirect potable reuse (IPR) project.

RATES HOLDING STEADY: Rates are moderately high but are expected to remain unchanged over the forecast period barring any revisions to capital needs for PLWTP or the IPR.

EXTENSIVE SERVICE TERRITORY: The service area is broad and diverse.

RATING SENSITIVITIES

REDUCED FINANCIAL STRENGTH: Maintenance of sound financial metrics will be key to preserving credit quality.

CAPITAL ESCALATION: Ultimate timing and costs associated with conversion of PLWTP to full secondary and/or construction of the IPR project will be a significant consideration in credit quality over the coming years.

CREDIT PROFILE

REGIONAL UTILITY WITH FAVORABLE ECONOMIC UNDERPINNINGS

The system provides retail service to around 1.3 million people within the city and also provides wholesale service to approximately 800,000 people in the outlying area. The city's diverse economy is driven by healthcare, military, tourism, and educational sectors. Economic conditions in the city

have shown positive signs over the last couple of years, with job growth in the city expanding by 2.3% in 2013 alone. This growth pushed city unemployment levels in 2013 down to 7.4%, in line with that of the U.S. after lagging the national rate for the last several years.

FINANCIAL RESULTS CONTINUE TO BE STABLE AND SOUND

System financial performance is good and includes strong liquidity and favorable cash flows. For fiscal 2013, the system maintained over 780 days cash while free cash generated from operations equaled 104% of depreciation expenses. Annual debt service coverage (DSC) of all debt was also sound in fiscal 2013 despite a 2% decline in operating revenues resulting from reduced flows and no rate increase for the year. Overall, total DSC was 1.7x in fiscal 2013, similar to the last five fiscal years. Financial projections provided by management anticipate some erosion in DSC through fiscal 2018 resulting from limited additional debt issuance, modest growth in operating expenses and no further rate hikes. Maintenance of satisfactory DSC will be important to preservation of the current rating.

IMPROVING DEBT PROFILE BUT POSSIBLE OUTYEAR PRESSURES

Capital needs for fiscals 2014-2018 total around \$510 million. These costs are around 5% higher than the fiscal 2012-2016 capital improvement program (CIP) as a result of inclusion of additional renewal and replacement of assets. Despite the increased CIP, costs remain well below recent year CIPs given that regulatory requirements from consent decree projects have been completed.

Debt levels remain moderate, but are forecasted to decline over the immediate future because of minimal borrowing plans and rapid amortization of existing debt. While the anticipated improvement in the system's debt profile is a positive, capital costs could escalate substantially in the latter or subsequent years of the CIP to meet future discharge requirements at PLWTP and/or to construct the IPR. Such projects are not currently included in the system's CIP but could lead to substantial future borrowings.

Currently, PLWTP operates under a 301(h) waiver of the federal Clean Water Act, allowing the facility to treat to advanced primary standards. The city received its most recent waiver in August 2010, which expires in July 2015. It is likely that sometime after the expiration of the renewed permit additional enhancements to the system will be required, which could include conversion of PLWTP's treatment process to full secondary. Alternatively, the city is pursuing the IPR project (estimated capital cost of \$369 million) which is expected to reduce total system flows by around 10% through enhanced treatment and diversion of such flows to San Vicente Reservoir for potable consumption and allow PLWTP to remain an enhanced primary treatment facility.

If PLWTP is required to upgrade to full secondary treatment, recent capital cost estimates are as high as \$1.5 billion. Costs allocable to the system for construction of the IPR are currently unknown but would likely be based on avoided capital costs directly attributable to the IPR estimated at \$123 million, including avoided annual operating costs; the water system would likely bear the majority of the capital and operating costs of the IPR, if constructed. Fitch will continue to monitor these regulatory developments and assess the possible impact they could have on the system's credit profile.

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In addition to the sources of information identified in the U.S. Municipal Revenue-Supported Rating Criteria, this action was additionally informed by information from Creditscope and IHS Global Insights.

Applicable Criteria and Related Research:

- 'Revenue-Supported Rating Criteria' (June 2013);
- 'U.S. Water and Sewer Revenue Bond Rating Criteria' (July 2013);
- '2014 Water and Sewer Medians' (Dec. 2013);
- '2014 Outlook: Water and Sewer' (Dec. 2013).

Applicable Criteria and Related Research:

2014 Outlook: Water and Sewer Sector

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=724357

2014 Water and Sewer Medians

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=724358

U.S. Water and Sewer Revenue Bond Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=715275

Revenue-Supported Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=709499

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